Strategy Focus

5 October 2007 | 10 pages

# India Equity Strategy

## Sep-07 Quarterly Results Preview

- **Sensex ex-oil profits to rise 21% yoy** — After a robust 1Q, we expect Sensex ex-oil profits to rise by 21% in 2QFY08 (14.5% for Citi India universe ex-oil). Forex gains (a key driver of positive surprises last quarter) will likely be less of a factor this time, as the rupee appreciated by a modest 2% during the Sep-07 quarter.
- **Topline growth moderation to continue; stable margins** — With base effect and slowing credit, we expect trend of top-line growth (ex-oil) moderation to continue; we forecast ~13% for Sep-07 quarter. Margins should hold steady overall, despite challenges of wage inflation and currency appreciation for many sectors.
- **Expected leaders and laggards** — Telecom (+114%), Media (+109%), Brokerages (91%), Hotels (54%), Capital Goods (47%), and Cement (50%) should lead in profit growth. Key laggards seen as Autos, Pharma, Textiles, Metals, and Sugar. IT Services (18%) will likely also be slightly behind market averages in terms of profit growth.
- **Will results season back up the strong market recovery?** — A liquidity surge after the Fed rate cut has driven a stunning 27% rise in Sensex from lows just six weeks back. Positive earnings surprises will be key to hold up that momentum. The previous quarter's earnings surprises, outside the capital goods sector, were mostly from forex gains and hence it did not drive any significant earnings revision (Sensex ex-oil earnings growth for FY08E and FY09E is still around 16-17%). We expect earnings surprises / revisions to remain on a slow track (though positive).

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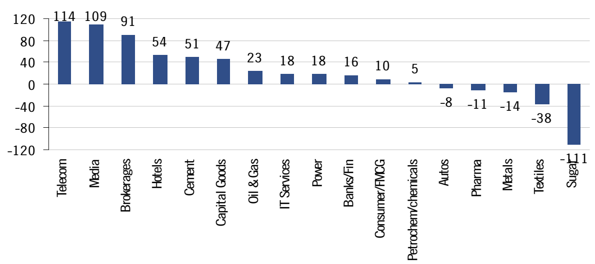
**Figure 1. Sep-07 Quarter: Forecast Sectoral Profit Growth (Percent YoY)**




Source: Citi Investment Research estimatest

**See Appendix A-1 for Analyst Certification and important disclosures.**


[1]Citigroup Global Markets India Private Limited

# Sep-07 Quarterly Results Preview

**We expect a steady quarter of earnings for Indian companies and expect profits for Sensex ex-oil to rise by 21% yoy. Driven by credit moderation and some base effect, top-line growth should continue to moderate. Although currency appreciation and cost pressure will likely impact margins in some sectors, overall margins are likely to hold steady. After a stunning rebound in the market (up 27% in last six weeks), the results season needs to back it up with positive surprises to sustain the momentum. In the June quarter, although overall profit growth was better than expected, much of the positive surprise outside of capital goods sector was driven by forex gains and other one-offs, leading to very modest upward earnings revision. Currency will be less of a factor this time (appreciation of 2% in Sep-07 quarter). With limited margin levers and moderation in top-line growth, we expect earnings surprises / revisions to remain on a slow track in India.**

## Sensex ex-oil profits expected to rise 21% yoy

Sensex ex-oil profits are forecast to rise 20.8% yoy for Sep-07 quarter, while overall Sensex profits are expected up 17.7%. Profit growth for the broader Citi India coverage universe (155 companies) is also expected to rise a solid 17% yoy (14.6% ex-oil).

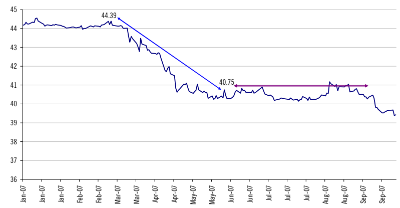
Leading sectors in terms of profit growth are likely to be Telecom, Media, Brokerages, Hotels, Capital Goods and Cement, while Sugar, Textiles, Metals, Autos and Pharma will likely be laggards this quarter. IT services should also slightly lag the market average profit growth. (Please refer to Figure 2 below for sectoral breakdown of profit growth for recent 10 quarters.)

**Figure 2. India Quarterly Profit Growth by Sector (Percent YoY)**

| | FY06 | | | | FY07 | | | | FY08 | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Year to 31 March** | **1Q** | **2Q** | **3Q** | **4Q** | **1Q** | **2Q** | **3Q** | **4Q** | **1Q** | **2QE** |
| **Sensex** | **30.3** | **22.1** | **12.7** | **11.4** | **30.2** | **26.4** | **41.7** | **30.4** | **30.5** | **17.7** |
| **Sensex - ex-Oil** | **27.0** | **22.0** | **13.1** | **25.3** | **31.9** | **34.5** | **48.0** | **36.5** | **35.3** | **20.8** |
| **Citigroup Universe (155)** | **10.8** | **15.5** | **7.6** | **47.9** | **29.4** | **57.7** | **59.6** | **12.6** | **48.5** | **17.0** |
| **Citigroup Universe - ex-Oil** | **26.4** | **21.1** | **25.7** | **38.3** | **38.1** | **52.1** | **51.5** | **32.6** | **33.2** | **14.5** |
| Autos | 29.4 | 29.4 | 31.3 | 30.7 | 49.0 | 34.0 | 24.5 | 14.1 | -8.4 | -7.7 |
| Banks/Fin | 1.5 | 13.3 | 24.2 | 17.4 | -2.2 | 17.8 | 20.8 | 21.3 | 40.0 | 15.7 |
| Brokerages | 436.2 | 398.7 | 232.9 | 174.8 | 85.9 | 38.7 | 36.0 | 53.3 | 86.1 | 91.3 |
| Capital Goods | 93.5 | 40.0 | 112.1 | 98.2 | 125.1 | 116.7 | 59.6 | 34.3 | 38.1 | 46.8 |
| Cement | 23.2 | 4.3 | 2.4 | 76.0 | 109.9 | 152.3 | 251.9 | 61.1 | 32.2 | 50.7 |
| Consumer/FMCG | 21.0 | 18.1 | 27.8 | 23.5 | 24.2 | 35.4 | 17.8 | 24.5 | 21.8 | 9.6 |
| Hotels | NA | NA | 19.7 | 55.3 | 63.2 | 67.8 | 74.0 | 83.5 | 42.4 | 54.3 |
| IT Services | 18.8 | 24.1 | 27.9 | 47.4 | 47.2 | 48.2 | 44.2 | 43.8 | 35.7 | 17.9 |
| Media | 20.5 | -27.0 | -56.3 | -7.0 | -1.3 | 19.2 | 287.2 | 3.6 | 32.5 | 109.3 |
| Metals | 72.6 | 47.5 | 81.5 | 156.3 | 107.7 | 147.2 | 102.6 | 25.0 | 15.1 | -14.3 |
| Oil & Gas | -32.6 | 1.5 | -39.3 | 74.5 | -16.2 | 74.6 | 103.0 | -31.2 | 179.7 | 23.4 |
| Petrochem/chemicals | 70.4 | 35.0 | -20.3 | -14.6 | -2.8 | 9.9 | 55.6 | 14.8 | 29.1 | 4.5 |
| Pharma | 11.3 | -16.6 | 9.8 | 51.5 | 38.8 | 91.6 | 72.6 | 116.2 | 28.5 | -11.5 |
| Power | 24.7 | 11.5 | 11.4 | 17.9 | 19.2 | 20.5 | 21.1 | 17.7 | 48.6 | 17.7 |
| Sugar | 318.9 | 68.3 | 15.9 | 85.3 | 39.1 | 118.4 | -43.1 | -83.6 | -183.4 | -110.9 |
| Telecom | 22.4 | 27.2 | 34.7 | 43.2 | 237.9 | 171.8 | 138.0 | 95.3 | 120.3 | 114.2 |
| Textiles | 305.9 | 100.8 | 117.2 | 37.4 | 10.4 | 93.7 | 16.2 | -13.5 | 16.3 | -37.6 |

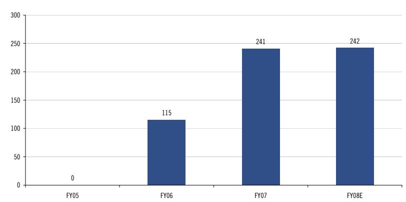
Source: Citi Investment Research estimates

**Figure 3. INR/USD, 2007 YTD**




Source: Datastream

**Figure 4. Oil-bond Issuance to Oil Companies**




Source: Citi Investment Research

The previous results season had seen well above expected profit growth – but much of the earnings surprise outside of the capital goods sector came from forex gains and other one-offs. Not surprisingly, despite a strong Jun-07 quarter, earnings upgrade momentum has been very muted and Sensex ex-oil earnings growth for FY08E and FY09E is still expected to be 16-17%.

With the rupee appreciating a mere 2.1% vs. the US dollar in the Sep-07 quarter (6.1% in the preceding quarter), forex gains will play a far smaller role in driving earning surprises this time around.

Our oil sector estimates incorporate oil-bond issuance to the tune of about Rs240bn for FY08E, and Rs121bn in the first half, all of which would accrue in this quarter. High refining margins had bailed out the sector in the Jun-07 quarter. Despite refining declining significantly qoq and sustained losses on the marketing side, bunched up oil bond issuance should drive sector profits up around 23% yoy.

## Slower top-line growth, margins to hold steady

Top-line growth has been moderating in recent quarters and the latest results should sustain that trend. We expect sales growth of around 13% for both Sensex ex-oil and Citi ex-oil universe. Significant moderation in credit growth and base effect are primary drivers of slower top-line growth.

Brokerages, Capital Goods and Telecom are expected to lead in top-line growth, while global commodities (metals, oil, sugar) and autos will likely be key laggards.

**Figure 5. India Quarterly Sales Growth by Sector (Percent YoY)**

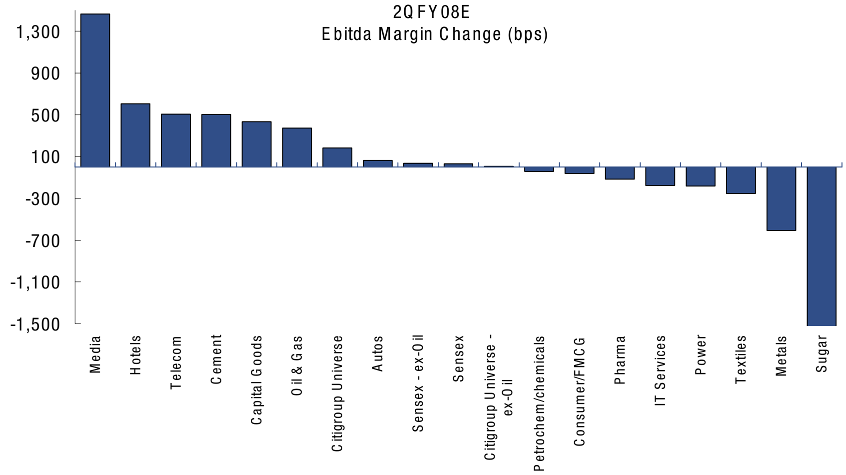
| | FY06 | | | | FY07 | | | | FY08 | |
|---|---|---|---|---|---|---|---|---|---|---|
| **Sales** | **1Q** | **2Q** | **3Q** | **4Q** | **1Q** | **2Q** | **3Q** | **4Q** | **1QA** | **2QE** |
| **Sensex** | **23.4** | **22.5** | **15.8** | **24.4** | **30.8** | **30.1** | **34.7** | **20.8** | **15.9** | **11.4** |
| **Sensex – ex-Oil** | **26.4** | **25.1** | **18.0** | **28.4** | **30.4** | **33.0** | **36.1** | **22.8** | **19.1** | **12.9** |
| **Citigroup Universe** | **18.3** | **24.1** | **27.1** | **34.6** | **35.3** | **41.2** | **29.8** | **18.0** | **13.5** | **6.8** |
| **Citigroup Universe - ex-Oil** | **27.2** | **33.2** | **36.5** | **41.3** | **37.7** | **41.9** | **35.2** | **26.1** | **20.4** | **12.7** |
| Autos | 14.4 | 19.1 | 20.5 | 30.7 | 36.6 | 37.1 | 26.0 | 13.9 | 8.6 | 0.1 |
| Banks/Fin | 27.8 | 15.9 | 16.5 | 14.3 | 20.2 | 26.2 | 26.6 | 29.2 | 15.3 | 19.5 |
| Brokerages | 527.5 | 304.0 | 194.8 | 144.6 | 102.6 | 56.7 | 74.0 | 99.2 | 81.3 | 93.5 |
| Capital Goods | -8.8 | 31.2 | 84.7 | 62.2 | 76.0 | 92.3 | 39.1 | 42.2 | 36.9 | 34.6 |
| Cement | 39.8 | 29.8 | 33.3 | 47.8 | 36.3 | 33.5 | 49.2 | 38.0 | 22.3 | 26.7 |
| Consumer/FMCG | 16.8 | 49.0 | 60.4 | 52.2 | 59.1 | 31.5 | 24.0 | 34.1 | 19.7 | 19.6 |
| Hotels | NA | NA | 19.3 | 10.8 | 27.2 | 23.8 | 25.7 | 34.4 | 24.8 | 27.4 |
| IT Services | 40.1 | 37.5 | 46.0 | 48.6 | 45.0 | 47.4 | 40.8 | 39.6 | 28.7 | 24.0 |
| Media | 65.3 | 52.6 | 77.3 | 59.7 | 18.4 | 34.4 | 15.3 | 6.5 | 6.0 | 3.2 |
| Metals | 74.3 | 80.7 | 114.4 | 144.6 | 72.2 | 74.1 | 49.8 | 23.4 | 13.6 | -1.2 |
| Oil & Gas | 9.2 | 14.5 | 17.1 | 26.7 | 32.4 | 40.3 | 23.1 | 7.5 | 4.7 | -0.6 |
| Petrochem/chemicals | 25.9 | 29.9 | 4.0 | 19.3 | 20.9 | 34.3 | 43.0 | 5.5 | 13.6 | -6.1 |
| Pharma | 23.2 | 7.8 | 18.2 | 26.0 | 21.5 | 50.9 | 38.5 | 54.1 | 22.6 | 8.4 |
| Power | 11.6 | 15.1 | 19.2 | 11.2 | 18.1 | 15.6 | 18.7 | 20.9 | 23.8 | 16.3 |
| Sugar | 132.4 | 48.6 | 48.7 | 134.5 | 46.3 | 62.4 | 8.7 | 23.9 | 0.5 | -11.4 |
| Telecom | 20.9 | 22.6 | 25.4 | 22.6 | 40.7 | 30.9 | 41.3 | 31.9 | 35.7 | 49.2 |
| Textiles | 25.3 | 34.0 | 57.0 | 37.7 | 26.9 | 34.8 | 15.6 | 18.0 | 17.9 | 13.3 |

Source: Citi Investment Research estimates

EBITDA margins for the Citi India Coverage Universe are expected to be steady at 19.3% despite currency appreciation and cost pressure. Sectoral trends, however, are expected to be very divergent. While sectors like Media, Hotels, Telecom and

Cement should have strong margin expansions, sugar, metals, textiles, power, and IT services are likely to see their margins erode on a yoy basis.

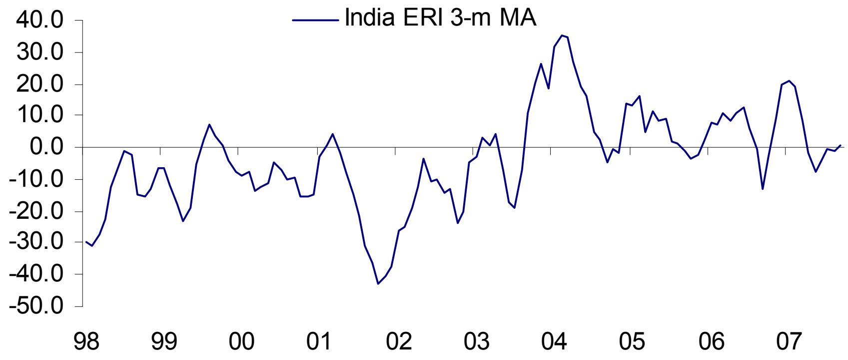
**Figure 6. Forecast Sep-07 Quarter EBITDA Margin Changes (bps)**




Source: Citi Investment Research estimates

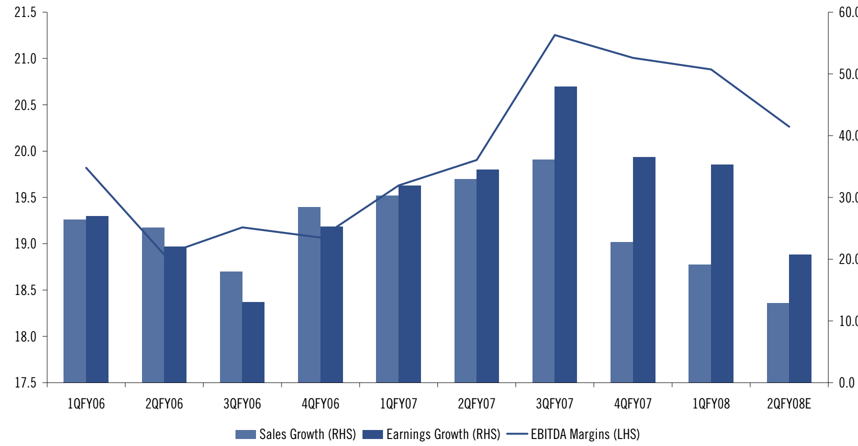
As mentioned earlier, earnings revisions have been on a slow track in India in recent months. Our current estimate for Sensex ex-oil earnings growth is still at 17% for FY08E, and 16.7% for FY09E, not very much higher than when the year began. With moderation in top-line growth and limited margin levers, we expect earnings surprises /revisions for the overall market to remain on a slow track. Sectors still seeing significant top-line growth and margin expansion – i.e., Capital Goods, Telecom, Media, Hotels, Cement – hold the maximum promise of positive earnings surprises.

**Figure 7. India Earnings Revision Index**




Source: IBES, Citi Investment Research. Earnings Revisions Index = (Number of companies with earnings being revised up – Number of companies being revised down)/Total number of companies being revised

**Figure 8. Sensex Profit Growth, Sales Growth, and EBITDA Margins Trend (Percent YoY)**




Source: Citi Investment Research estimates

## Select Sector Notes

**Autos**: The sector's performance will likely remain weak overall, with high interest rates continuing to have a negative impact on two-wheelers and four-wheelers alike. Sales for the sector are expected to remain flat on a yoy basis, while profits should decline. Likely best performers: Amtek Auto (AMTK.BO - Rs373.00; 1M), Amtek India (AMTI.BO - Rs159.25; 1M).

**Banks**: Pre-provision profits expected to rise by 23% with private banks likely to report substantially stronger growth (32%) relative to public sector banks. The sector has potential upside from bond portfolio appreciation and a facilitative trading environment. Expect strong performances from brokerages and possible earning dip for a few public sector banks to due to a high base effect. Likely top performers: Kotak (KTKM.BO - Rs994.00; 2M), IL & FS (ILFI.BO - Rs189.35; 3M), and Indiabulls (IBUL.BO - Rs636.00; 3M).

**Capital Goods**: Strong forecast earnings growth of 47% led by expected top-line growth of 35%, and margin expansion. Likely top performers: Thermax (THMX.BO - Rs712.05; 1L), Punj Lloyd (PUJL.BO - Rs320.00; 1L), Jindal Saw (JIND.BO - Rs620.00; 1M), L&T (LART.BO - Rs2,892.00; 1L) and BHEL (BHEL.BO - Rs2,070.15; 1L).

**Cement**: Higher cement prices should drive margin improvements. One-offs also expected to contribute positively. Profits likely up by almost 50% on a top-line growth of 27%. Likely top performers: ACC (ACC.BO - Rs1,228.00; 3M) and UltraTech (ULTC.BO - Rs1,102.00; 3M).

**Consumer**: Expect a weak quarter with profit growth seen at only around 10%, despite a 20% top-line growth. Expected top performers: Britannia, and Marico. Likely laggards: TataTea (TTTE.BO - Rs845.00; 1L), Colgate (COLG.BO - Rs419.00; 1L), and Shoppers' Stop (SHOP.BO - Rs517.25; 3M).

**Hotels**: We expect margin improvement due to strong ARR growth, and operating leverage, to provide earnings growth of about 54%, including a low-base effect for EIH due to swap-loss accrued last year.

**IT Services**: Expect strong volume growth should continue in a seasonally strong quarter. EBITDA margins seen down yoy, but likely to improve sequentially for most companies with visa costs and wage hikes being taken care off in 1Q. Likely top performers: Mphasis BFL (MBFL.BO - Rs288.00; 1M), and NIIT (NIIT.BO - Rs147.50; 3M). Laggards: Sasken (SKCT.BO - Rs321.00; 1M).

**Media**: Top-line growth expected to be marginal at about 3%, but with Zee hiving off loss-making businesses, EBITDA margins have shot up, and earnings are expected to grow by about 109% this quarter. Likely top performer: Zee (ZEE.BO - Rs346.55; 1L).

**Oil&Gas**: We have assumed oil-bond issuance to the tune of Rs240bn for this fiscal, with Rs121bn for the first half, to be booked in this quarter. Earnings growth is expected at around 23% for the sector, with top-line growth flat, and margin improvement of around 370bps. Refining and marketing margins for downstream oil majors are expected to fall by US$2-3/bbl and Rs0.50 respectively on qoq basis. Rupee appreciation is likely to have a significant positive impact on gas distributors. Likely top performers: Aban (ABAN.BO - Rs3,594.10; 1M), Gujarat Gas (GGAS.BO - Rs313.00; 1L) and GAIL (GAIL.BO - Rs376.50; 1L).

**Pharma**: Impact of currency appreciation on exports and margins should lead to a weak quarter with revenue growth in single-digits at 8%, and negative profit growth (-11%). Base effect should have a positive impact on Matrix (MAXL.BO - Rs233.00; 3M), and a negative impact on Dr. Reddy's (REDY.BO - Rs656.00; 1M).

**Telecom**: Expect another strong quarter with profit growth well above 100% yoy. Forex gains in this quarter are likely but to a lesser than the previous quarter. Likely top performers: Idea Cellular (IDEA.BO - Rs133.80; 1L) and (RLCM.BO - Rs644.75; 1M).

# Appendix A-1

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Investment ratings are determined by the ranges described above at the time of initiation of coverage, a change in investment and/or risk rating, or a change in target price (subject to limited management discretion). At other times, the expected total returns may fall outside of these ranges because of market price movements and/or other short-term volatility or trading patterns. Such interim deviations from specified ranges will be permitted but will become subject to review by Research Management. Your decision to buy or sell a security should be based upon your personal investment objectives and should be made only after evaluating the stock's expected performance and risk.

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